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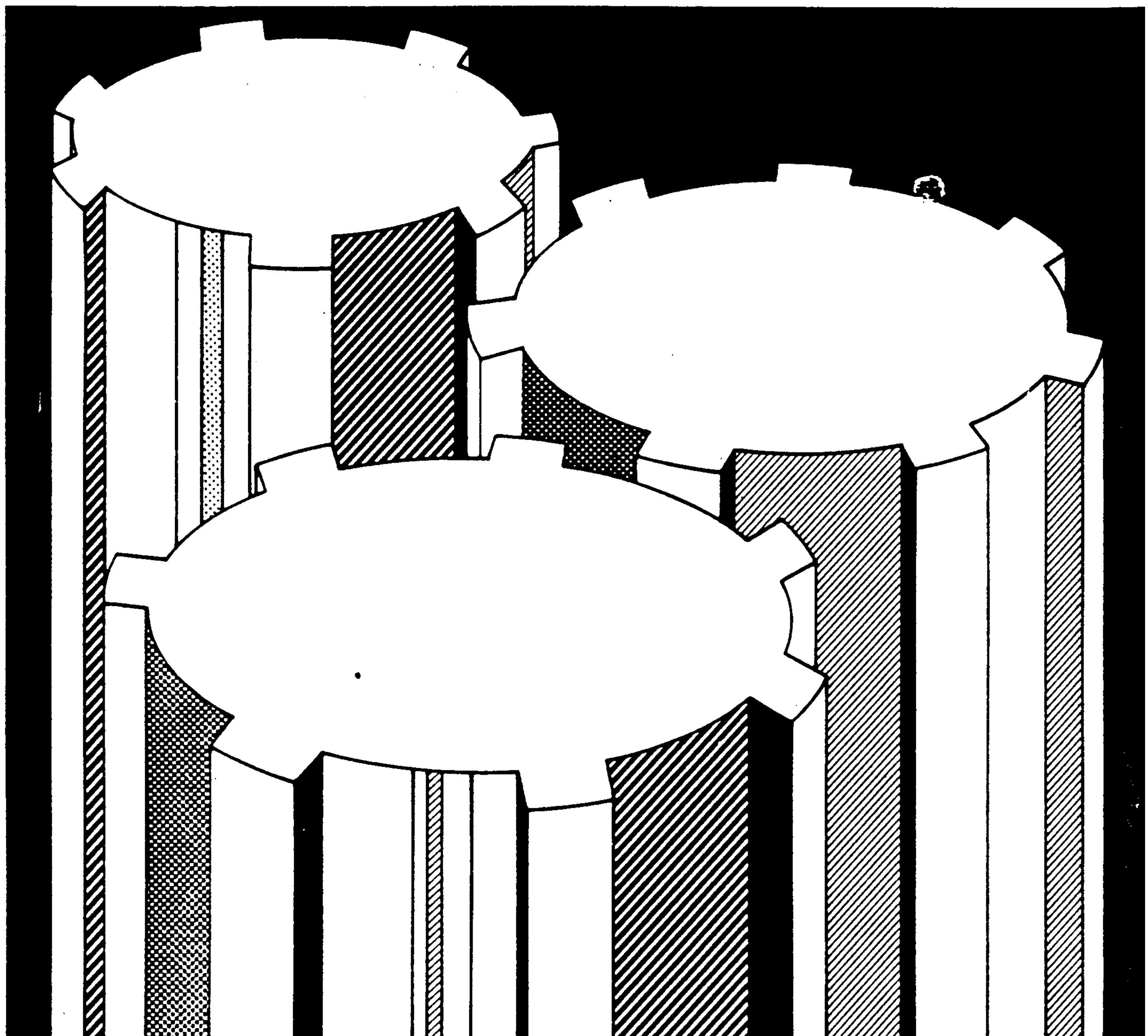
Has Trade Protection Revitalized Domestic Industries?



CBO STUDY

PREFACE

Growing imports have forced many domestic industries to reduce output and lay off workers. On a number of occasions, the United States has provided trade protection to such industries. These restraints on imports are intended to provide domestic firms with the time and the resources to compete more effectively with foreign producers. This study considers the effects of trade protection in revitalizing domestic firms in four cases--textiles and apparel, steel, footwear, and automobiles. It also discusses options that the Congress should consider in devising policies for industries injured by import competition. The report was prepared at the request of the Subcommittee on Trade, House Committee on Ways and Means. In keeping with the mandate of the Congressional Budget Office (CBO) to provide objective analysis, the report makes no recommendations.

Daniel P. Kaplan of CBO's Natural Resources and Commerce Division wrote the report under the supervision of Everett M. Ehrlich. Peter Siegleman made important contributions in the early stages of the project. Wayne Glass, Andrew Horowitz, Stephen Parker, and Elliot Schwartz of CBO provided helpful suggestions. Robert Crandall, Charles Bremer, Fawn Evenson, John Kwoka, Daniel Luria, Carl Priestland, Louis Schorsch, Reuben Schwartz, David Tarr, and George Wino provided valuable comments. Any errors, however, remain the responsibility of the author. The report was edited by Paul L. Houts, and the manuscript was typed and prepared for publication by Kathryn Quattrone, Gwen Coleman, and Pat Joy.

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SUMMARY

International trade has grown rapidly since the end of World War II. Reductions in tariffs and improvements in communication have lowered the costs of importing goods produced in other countries. Moreover, new producers are emerging as developing countries industrialize. As a result, producers in the United States and elsewhere are facing increased competition from foreign producers.

With imports at historically high levels, the Congress has considered numerous proposals to increase the competitiveness of domestic industries. This report investigates whether trade protection was successful in restoring international competition in four cases--textiles and apparel, steel, footwear, and automobiles--and examines trade policy options that the Congress might consider in the light of these episodes.

International trade increases a nation's overall economic welfare by enabling it to specialize in those goods and services that it can produce relatively efficiently. At the same time, however, some industries may have difficulty in competing against foreign firms. To aid these industries, the United States has on a number of occasions granted them trade protection, which provides direct and immediate benefits to labor and capital employed in the industry. Nevertheless, protection is generally awarded for a limited period of time. It is not uncommon, however, for an industry to have more than one period of trade restraints.

The primary purpose of protection is to enable an industry to adjust to changed competitive circumstances. On the one hand, it is supposed to accomplish this goal by allowing the industry to contract more gradually than it otherwise would have and thereby ease the transition of resources employed in the industry to other sectors of the economy. Alternatively, trade protection is intended to provide an industry the time and resources to compete more effectively. If one examines the intent of trade legislation, however, the revitalization of the industry is clearly the more important of these conflicting objectives. The question is whether protection has, in fact, revitalized industries injured by foreign exports.

THE COSTS AND BENEFITS OF PROTECTION

Trade restraints impose a number of significant costs on the economy. To begin, they raise the prices that consumers must pay for imports and their protected domestic substitutes. Moreover, they hamper the efficiency of the economy. In a fully employed economy, increased imports in an industry encourage resources employed there to be shifted to other sectors where they can be used more productively. By specializing in the goods and services it can produce relatively efficiently and importing those that can be produced more inexpensively elsewhere, a nation can increase the amount that it has available to consume and invest. Protection limits this process.

While trade improves a nation's welfare, not all segments of the economy necessarily benefit. For example, in many developing nations, labor is relatively abundant and consequently prevailing wages are much lower than those in the United States. As a result, firms in these countries can produce many labor-intensive products at lower cost than domestic firms. Moreover, a domestic industry that has successfully competed in international markets may become less successful over time. It might lose its competitive edge, for example, if its technology became standardized and readily appropriable by foreign firms.

In the short run, the primary benefit of protection in a fully employed economy is that workers who would have been laid off remain productively employed during what otherwise would have been a spell of unemployment. If the industry has not adjusted during the period of protection, however, the economy will have to bear costs of adjustment once the restraints lapse. If the industry does adjust in the long run, the primary benefit will be that the economy has been spared the costs of workers being unemployed and the additional costs of their finding and training for new jobs. Although a protected industry will be larger as a result of restraints, in a fully employed economy other sectors will consequently be smaller. Society does not necessarily benefit from such transfers of resources.

A common source of the difficulties that domestic industries encounter is that their costs, and particularly their labor costs, are substantially higher than those of foreign producers. In fact, foreign producers may have lower costs even though they are less efficient; the lower price of inputs more than compensates for their more intensive use. In such situations, protection is supposed to enable an industry to improve its competitive position, but it does so only indirectly. First, restricting imports increases their price. Second, the resulting increased demand for domestic substitutes raises the prices, output, and profits of the domestic industry. Finally, higher profits enable domestic firms to invest either in new cost-reducing technologies or new products.

Trade protection cannot be expected to increase substantially a firm's incentives to invest in cost-reducing technologies. The higher output and prices that result from protection do not significantly affect the profitability of such an investment. If a new technology is supposed to reduce average costs by 10 percent, it would do so whether or not the industry was protected.

Increasing profits, however, may make it easier for a firm to obtain funds and thereby increase the expected profitability of investments. Thus, protection might restore an industry's cost competitiveness if it failed to make cost-reducing investments because of a lack of resources. If capital markets are reasonably efficient, however, then companies should be able to secure the requisite funds at an appropriate cost. In any case, if a lack of funds for investment is the source of an industry's problem, it would be less costly to the economy to provide the resources directly to the firm through loans or loan guarantees rather than indirectly through protection.

THE CASE STUDIES

The four case studies considered in this report include the largest industries that have received protection; they are also among the largest in the economy. Footwear and automobiles each had one episode of protection; steel had three; and the textile and apparel industries have had continuing and expanding protection since 1956. With the exception of the trigger price mechanism in the steel industry, which was instituted in 1978, protection has been provided by placing quotas on imports from significant foreign suppliers.

For the most part, the difficulties of these industries stem from their relatively high domestic costs, although declining domestic consumption has been a significant factor in the steel industry. Wages in the textile, footwear, and apparel industries are well below the average for all manufacturing, but they substantially exceed wage rates of many of the significant foreign suppliers. In contrast, wage rates in the domestic automobile and steel industries are not only higher than the principal foreign suppliers, they are also well above the average for all manufacturing.

The Effectiveness of Restraints

While the quotas succeeded in restricting output from the constrained sources, the effectiveness of the restraints was limited by a number of factors including source switching and product substitution. With the exception of automobiles, imports increased from unconstrained foreign producers. In apparel and footwear, foreign producers increased shipments of unconstrained substitute products. For example, Korean footwear manufacturers circumvented the quotas by reducing the amount of leather in their athletic shoes. In addition, quotas provide incentives for foreign suppliers to shift their product mix toward higher valued products, which are frequently more profitable market segments for domestic firms. Finally, by reducing demand for imported products, recessions lessen the impact of the restraints. For example, because auto demand slumped in 1981 and 1982, quotas probably did not have much of an effect on the sales of Japanese cars in those years.

Nevertheless, despite these drawbacks, the restraints limited imports for at least some of the time during which they were in effect. As a result, output, employment, and profits of the domestic industry were higher than they would have been without protection. On the other hand, to the extent the trade restraints increased profits in the steel and automobile industries, they may have helped to preserve the relatively high wage rates that is a source of the competitive difficulties experienced by those industries.

Profits and Investment

Although profits were higher because of the restraints than they would have been, in most cases they were not substantially higher than they had been before the restraints were imposed. The major exception was the U.S. automobile industry after quotas had been imposed on Japanese automobiles. There were no other foreign sources of comparable small cars, and so profits for domestic car producers rose substantially. In the shoe industry, quotas applied to only two nations, accounting for 54 percent of imports. Nevertheless, the shoe industry also registered a modest increase in profits in the final two years of the restraints.

The restraints did not increase investment in textiles, apparel, or steel. While investment in the auto industry rose in the last two years of the quotas, it is uncertain whether they contributed significantly to that increase. With the economic recovery, the automobile industry's profits would have increased significantly without the quotas. Moreover, despite the increased investment, the industry's debt as a percentage of stockholders' equity declined and was below the average of all manufacturers. In the footwear industry, however, quotas probably did increase investment. With its indebtedness above the average for all manufacturing, the footwear producers may have had difficulty in securing funds, so the profits from the quotas could have played a role in the greater investment. Yet, despite this increased investment, labor productivity in the footwear industry grew significantly more slowly than it did for all manufacturing, and thus the industry was not apparently able to close the significant gap in costs between it and its principal foreign competitors.

Competitiveness of the Industries

In none of the cases studied was protection sufficient to revitalize the affected industry. The steel industry recently received its third episode of protection after demonstrating to the International Trade Commission (ITC) that it had been seriously injured by import competition. Imports in the footwear industry have increased substantially since the quotas lapsed, and in 1985 the ITC again made a determination that the industry had been seriously injured. Imports of textile and apparel products also increased rapidly during the 1980s, accounting for an expanding share of domestic supply. Last year the Congress passed a bill, which was vetoed by the President, that would have placed tighter quotas on textile and apparel imports into the United States. Finally, despite five years of protection, the automobile industry is still facing strong competition from Japanese producers. In fact, the domestic automobile manufacturers have announced plans to rely increasingly on foreign producers to supply them with the small cars that have been the primary source of their competitive difficulties with Japanese manufacturers.

In sum, the experiences in these four cases suggest that the current system of trade restraints has not been sufficient to revitalize these industries. Furthermore, it is not at all clear that a lack of funds was the source of the industry's difficulty or that technologies were available that would erase the cost disadvantage of domestic producers.

POLICY OPTIONS

The above factors suggest that the United States should consider a number of other policy options in framing a new trade policy. It might, for example, adopt a more aggressive posture to revitalize industries, or shift the focus of the program to aiding workers displaced because of the contraction of industries, or end special treatment for trade-impacted industries. Moreover, when protection is used to help industries adversely affected by import competition, tariffs may be more appropriate than quotas.

Use Tariffs Instead of Quotas to Restrict Imports

In the cases considered in this report, quotas have been used to restrain imports, with the exception of one episode of protection in the steel industry. Quotas, however, present a number of problems. In the first place, when there are many potential suppliers of the restrained good, it is difficult to administer a quota system that covers all of them. Second, by allocating market shares, quotas reduce competition among countries. Third, quotas give foreign firms an incentive to shift their product mix toward higher valued goods. Fourth, under a quota, foreign producers capture the higher revenues resulting from the increased price. Tariffs do not have these problems. On the other hand, since quotas are generally negotiated with foreign governments and provide some financial benefit to foreign suppliers, they are less likely to invoke retaliation.

Increase the International Competitiveness of Domestic Industries

In most cases, the lower labor costs of foreign producers has been an important source of the competitive difficulties of domestic industries. To compete more effectively, therefore, domestic producers must invest in production processes that are less labor intensive. Coordinated action by firms to retire facilities and to establish new ones may increase the likelihood that firms will undertake such investments. A firm may be more likely to invest in a new facility if it knows that the construction of such a plant will not result in overcapacity. These actions could be coordinated by a panel consisting of representatives from various sectors--consumer groups; federal, state, and local governments; and firms in the industry as well as their employees. The panel might also consider issues such as wage concessions and aid for displaced workers. As part of the panel's revitalization plan, the government could provide loans or other assistance to help finance needed investment. The prospect of such aid might also provide an incentive for members of the industry and labor to agree to such a plan.

On the other hand, the marketplace itself provides substantial incentives for firms to undertake investments to reduce their costs, even without a panel. While coordinated action by the firms of an industry could seriously impair competition, it is far from clear that any such plan could revitalize an industry. Furthermore, it is even questionable whether the panel would be able to agree on a plan that was acceptable to all groups.

Focus on Workers Who Have Been Displaced by Import Competition

With existing technologies and prevailing relative labor costs, it may be that many of these industries that have been injured by imports will be unable to maintain their current scale of operation in the face of foreign producers with lower costs. Moreover, the government can probably do little to change this situation. Rather than attempting to revitalize these industries, one option would be to shift the role of the government to reducing the costs that result from workers being displaced.

Such programs would be designed to increase the mobility of workers among jobs and regions of the country. For example, once the ITC had determined that an industry had been injured by increased imports, workers would be eligible for job training and relocation grants. Since displaced workers generally take a pay cut in their new jobs, the government might also temporarily make up part of any difference. These programs could be financed by a tariff on imports of the affected product, a tax on domestic output of the product, a general increase in tariffs, or some combination of the above. Thus, under this option, the role of trade protection would be limited to raising revenues.

In certain circumstances, trade protection might be used to ease the cost of an industry's contraction. If the affected industry is a substantial employer in a particular community, an abrupt increase in the number of workers looking for work may be too much for the local labor market to handle. In addition, such a sharp contraction might place a financial strain on the local economy and municipal government. By allowing a more gradual contraction of the industry, protection can allow the local labor market to work more efficiently, as well as enable the local government to prepare for the decline of its major industry.

End Special Treatment for Industries Injured by Imports

A final option is to end the distinction between industries and firms that contract because of foreign competition and those that contract for other reasons. In a competitive economy, an increase in imports is just one of many reasons that firms and industries contract. Industries can be adversely affected by changes in tastes, and particular firms can be hurt by domestic competition. The adverse effects on communities and workers from a reduction in output are the same regardless of the reason for it. One can, therefore, argue that it is inequitable to provide special treatment to only those industries that contract because of import competition. Rather, programs should be designed to address the generic problem of displaced workers and adversely affected communities.